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Poland: a promising start into 2006

The accession to the EU spurred Poland's growth in 2004. However, much of that growth was due to a very strong accumulation of inventories. The gradual reduction in the abnormally high inventories took another year and resulted in much lower growth rates from the third quarter of 2003 through the third quarter of 2005. Finally, in the fourth quarter of 2005 stronger growth resumed, this time without excessive changes in inventories. In the first quarter of 2006 growth accelerated further, from 4.3% (4Q2005) to 5.2%. At the same time there has been some improvement in the structure of growth: The contribution of foreign trade (goods and services) to the growth rate rose from -1.1 percentage points to +0.7 p.p. (and the contribution of domestic demand was reduced from 5.4 p.p. to 4.5 p.p.).

After more than a year of very weak growth, private consumption increased significantly, by 5.1% (1Q2006). This development appears consistent with rising employment (in the corporate sector alone by close to 2%) and rising wages and other incomes. The total wage bill (of firms and institutions employing over 9 persons) rose over 5% and the total of retirement pays and pensions disbursed by about 2% (both items in real terms). Moreover, the expansion of private consumption was supported by rising credit extended to the household sector. The stock of household credit outstanding rose some 27% (of which housing credit – which accounts for one third of the total – by 46%).

Rising wages have not yet eroded profits. On the contrary, the corporate non-financial sector (firms employing over 50 persons) continues making huge profits. In the 1Q2006 the net (post-tax) profits rose 8.7% vs. the same period of 2005, surpassing PLN 12 billion. The banking sector (commercial and co-operative, combined) performed even better: its net profits rose by 40%, to close to PLN 3 billion.

In the first quarter of 2006 gross fixed investment rose respectably, by 7.4%.[1] But it is not yet quite clear whether the long-awaited sustainable recovery of the investment activity is firmly underway. Imports of machinery and transport equipment have not been accelerating visibly, while the domestic supply of capital goods, which increased strongly in the first quarter of 2006, contracted already in April 2006. Of course, there are good grounds to expect a further strengthening of investment activities. The corporate sector has been making large profits for quite some time and its financial standing is, on the whole, excellent. The sector is highly liquid, with some 70% of firms reportedly having no problem with liquidity.[2] Actually, 32% of

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[1] The current volume of gross fixed investment is at the same level registered already five years ago.

[2] See the report on the business climate in the second quarter of 2006 (accessible on the web page of the National Bank of Poland, www.nbp.pl/publikacje/koniunktura).

firms report excess (or surplus) liquidity. The share of firms meeting their financial obligations on time is high (92%) and rising. Non-financial firms' deposits with the banking system rise much faster than those of households (over the last year by 17.7% vs. 3.1% respectively). Finally, the reluctance of firms to engage in investment more vigorously is hard to square with the fact that the current levels of capacity utilization (currently estimated at 81%) are the highest since 1999.

The attitude of the corporate sector apparently preferring an accumulation of liquid assets to the expansion of fixed capital need not be entirely irrational. Producer prices in manufacturing have been falling for over two years now. (The overall industrial producer price index for 2005 is 0.7% – only on account of strong rises in price indices for coal mining and for the output of the electricity and gas sector. This tendency has continued in 2006.)[3] Given an expectation of continuing deflation, it may make sense to defer major investments. This interpretation of the preference for liquidity seems consistent with information on credits to the corporate sector. Conditions might seem fairly conducive to financing investment with bank loans. Nominal interest rates on credits denominated in zloty are currently not excessive. The average interest on long-term credit is about 6.1%, and on short-term credit about 6.3%. Interest rates on credits denominated in foreign currencies were 3.2% and 3.8% respectively, as of end-March 2006. (But the interest rates on credit denominated in foreign currencies have been set to rise.) Under 'normal' expected inflation of, let us say, about 2%, such conditions would probably have induced strong demand for credit – but not so with a rationally expected continuation of deflation. In effect one observes stagnation of credit to the corporate sector. (Since end-March 2005 the stock of that credit has risen by a mere 4%. Its share in the total stock of credit outstanding has fallen below 47%.)

Consumer price inflation has also been quite low: 0.8%. Similarly as producer price inflation, the CPI is positive primarily on account of stronger rises in the prices of household energy. Without rising energy prices, there would have been a consumer price deflation. The Monetary Policy Council of the National Bank of Poland, ostensibly targeting a 2.5% inflation (with a +/- 1 p.p. tolerance band) has again missed its target by a wide margin. The real interest rates following from its decisions have been too high – with the obvious consequences for both inflation, and investment.

The nominally high interest rates have provoked rather high inflows of portfolio capital (especially in the first half of 2005) and strengthened the zloty. A gradual lowering of the NBP interest rates (June-September 2005) did not prevent the strengthening of the zloty vs. the euro. Until February 2006, the zloty kept strengthening for nine months, on average

[3] The industrial producer price inflation for the first four months of 2006 is 0.9% (vs. the same period of 2005). However, price indices for manufacturing fell 0.6%, while those for mining and electricity-and-gas rose 9.5% and 6.5% respectively.

by 1% per month. Two further cuts in interest rates in January and February 2006, combined with the ongoing monetary tightening in the euro area (and in the US) may have been responsible for the long-overdue weakening of the zloty. The current PLN/EUR exchange rate (4.04 at end-June) is more or less equal to the rate prevailing in early 2005. A further weakening is possible – and unlikely to do much harm to the real economy (in 2003 the average rate was 4.4, in 2004 4.5).

Poland's foreign trade performed quite well in 1-3Q2005 (and less so in 4Q2005). A modest improvement recorded in 1Q2006 may be expected to be further magnified in the future – provided the zloty does not start strengthening again. But such a strengthening seems unlikely as Poland's inflation is too low to provoke hikes in interest rates. Besides, the current fashion for higher interest rates in the US and the euro zone will not be conducive to appreciation of the zloty.

There are other positive developments to report. After several years of depression in wages, these finally seem to be moving ahead. Primarily, this is an effect of rising demand for labour, in particular skilled labour. After years of low investment in machinery and equipment, firms may be trying to make up for insufficient capital with more intensive employment of skilled labour. But such labour is now relatively difficult to find. The very high unemployment since 1999 has forced large-scale migration, even before Poland's accession to the EU. The huge gains in productivity and unit labour costs made during 2002-04 leave much room for some gains in wages. This will undoubtedly strengthen domestic demand and thereby provide some additional motivation for increased investment spending. Certainly, the rise in labour costs (which are offset, as far as external competitiveness is concerned, by the ongoing depreciation) will have some impact on inflation. But, given the current deflationary environment, some moderate inflationary impulses would be only welcome.

The new government, whose political and ideological priorities are largely irrelevant economically, has not yet instituted any legal or institutional changes that could be capable of affecting the economic life either positively or negatively. Of course, the wholesale purge of 'liberals' and other 'post-communists' from the posts (including the important ones) throughout the public sector will impair the latter's functioning. Otherwise, the new regime is still running on the budget worked out by the former, professional, administration. And, as the economy inherited from the liberal post-communists is in a fairly good shape, the new government may manage, to produce a satisfactory budget of its own.

Summing up, the current conditions are conducive to a further strengthening of fixed investment. This will be essential for growth in 2007 and beyond, primarily because the current levels of capacity utilization are already high. In 2006 foreign trade will continue to contribute positively to GDP growth. Private consumption is expected to firm under the impact of rising wages and employment. However, this overall optimistic scenario assumes that Poland does not slip into an outright deflation – which could have grossly negative consequences for growth and employment.

Table PL

Poland: Selected economic indicators

	2001	2002	2003	2004	2005 [1]	2005	2006	2006	2007
						1st quarter		forecast	
Population, th pers., end of period	38248	38219	38191	38174	38157	38162	38149	.	.
Gross domestic product, PLN mn, nom. [2]	779205	807860	842120	922157	980884	228670	240259	1050500	1119700
annual change in % (real) [2]	1.1	1.4	3.8	5.3	3.4	2.2	5.2	5	4.5
GDP/capita (EUR at exchange rate) [2]	5553	5480	5013	5327	6385	.	.	.	.
GDP/capita (EUR at PPP - wiiw) [2]	9600	9980	10210	11060	11690	.	.	.	.
Gross industrial production (sales)									
annual change in % (real)	0.6	1.1	8.3	12.6	3.8	0.7 [3]	12.4 [3]	7	7
Gross agricultural production									
annual change in % (real)	5.8	-1.9	-0.8	7.5	-2.1	.	.	.	.
Construction output total									
annual change in % (real)	-6.4	-0.3	0.9	-7.0	5.0	7.6 [3]	4.5 [3]	.	.
Consumption of households, PLN mn, nom. [2]	497809	531100	543203	582449	606750	150311	159343	.	.
annual change in % (real) [2]	2.2	3.3	1.9	4.0	2.0	1.4	5.1	3	3
Gross fixed capital form., PLN mn, nom. [2]	161277	151472	153758	165848	178366	27972	29745	.	.
annual change in % (real) [2]	-9.7	-6.3	-0.1	6.3	6.5	1.4	7.4	7	6
LFS - employed persons, th, avg. [4]	14207.0	13782.0	13616.8	13794.8	14115.8	13767.0	14189.0	.	.
annual change in %	-2.2	-3.0	0.6	1.3	2.3	2.2	3.1	.	.
Reg. employees in industry, th pers., avg.	2820.6	2670.5	2639.1	2663.1	2426.0 [3]	2411 [3]	2460 [3]	.	.
annual change in %	-4.5	-5.3	-1.2	0.9	1.1 [3]	1.2 [3]	2.0 [3]	.	.
LFS - unemployed, th pers., average [4]	3170.0	3431.0	3328.5	3230.3	3045.3	3199.0	2708.0		
LFS - unemployment rate in %, average [4]	18.2	19.9	19.6	19.0	17.8	18.9	16.0	17.5	17
Reg. unemployment rate in %, end of period [4]	17.5	18.0	20.0	19.1	17.6	19.3	17.2	.	.
Average gross monthly wages, PLN	2045.1	2097.8	2185.0	2273.4	2380.3	2415.5 [3]	2539.6 [3]	.	.
annual change in % (real, gross)	2.5	0.7	3.4	0.7	2.6	0.3 [3]	4.3 [3]	.	.
Consumer prices, % p.a.	5.5	1.9	0.8	3.5	2.1	3.6	0.8	2	2
Producer prices in industry, % p.a.	1.6	1.0	2.6	7.0	0.7	3.3	0.6	1	1.5
General governm.budget, EU-def., % GDP [5]									
Revenues	40.0	41.0	39.9	38.6	40.8	.	.	41.6	40.7
Expenditures	43.7	44.2	44.6	42.5	43.3	.	.	44.6	43.7
Deficit (-) / surplus (+)	-3.7	-3.2	-4.7	-3.9	-2.5	.	.	-3.0	-3.0
Public debt, EU-def., % of GDP [5]	36.7	39.8	43.9	41.9	42.5	.	.	45.5	46.7
Discount rate of NB % p.a., end of period	14.0	7.5	5.8	7.0	4.8	6.5	4.3	.	.
Current account, EUR mn	-6006	-5399	-4108	-8542	-3503	-1048	-1177	-3800	-3800
Current account in % of GDP	-2.8	-2.6	-2.1	-4.2	-1.4	-1.8	-1.9	-1.5	-1.4
Gross reserves of NB excl. gold, EUR mn	29031	27367	26000	25904	34536	28407	34952	.	.
Gross external debt, EUR mn	81461	81045	84818	94322	109815	97146	.	.	.
FDI inflow, EUR mn	6372	4371	4067	10279	6132	2355	2748	.	.
FDI outflow, EUR mn	-97	228	269	636	1180	93	130	.	.
Exports of goods, BOP, EUR mn	46537	49338	53836	65847	77107	17613	21266	88700	99300
annual growth rate in %	19.3	6.0	9.1	22.3	17.1	23.4	20.7	15	12
Imports of goods, BOP, EUR mn	55094	57039	58913	70399	79289	17875	21536	88800	97700
annual growth rate in %	5.2	3.5	3.3	19.5	12.6	17.7	20.5	12	10
Exports of services, BOP, EUR mn	10914	10545	9850	10812	13017	2612	3409	14600	16400
annual growth rate in %	-3.6	-3.4	-6.6	9.8	20.4	23.0	30.5	12	12
Imports of services, BOP, EUR mn	10021	9690	9408	10036	11465	2302	3090	12400	13400
annual growth rate in %	2.5	-3.3	-2.9	6.7	14.2	8.4	34.2	8	8
Average exchange rate PLN/USD	4.09	4.08	3.89	3.65	3.23	3.07	3.19	.	.
Average exchange rate PLN/EUR (ECU)	3.67	3.86	4.40	4.53	4.03	4.03	3.83	4.1	4.1
Purchasing power parity PLN/USD	1.85	1.83	1.84	1.87	1.93	.	.	.	.
Purchasing power parity PLN/EUR	2.12	2.12	2.16	2.18	2.20	.	.	.	.

Notes: 1) Preliminary. - 2) Revised data (FISIM adjustment, new methodology in government sector, new estimate of shadow economy, etc.). - 3) Enterprises with more than 9 employees. - 4) From 2003 according to census May 2002. - 5) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts and European Commission (Spring 2006).